Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

2 December 1983

MEMORANDUM FOR: [redacted]
Office of Intelligence Liaison
Department of Commerce 25X1

FROM : [redacted]
Chief, Economic Issues Branch
Office of European Analysis 25X1

SUBJECT : US-EC High Level Consultations

1. Per your request, I am forwarding the attached material for you to pass to Under Secretary Olmer and Deputy Assistant Secretary Vargo. I hope they will find it useful in preparing for the 9 December US-EC consultations. I have included a short paper on EC budget problems and the potential impact on the US; the Key Judgments to a forthcoming intelligence assessment, Western Europe: The Unemployment Crisis; and an intelligence assessment we completed last September, New Departures in European Political Cooperation. 25X1

2. If I can be of any further assistance, you can contact me [redacted] 25X1

[redacted]

Attachments:
As stated

EURM 83-10273

[redacted] 25X1

25X1 [redacted]

Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

2 December 1983

MEMORANDUM FOR: [redacted] 25X1
Office of Intelligence Support
Department of Treasury

FROM : [redacted] 25X1
Chief, Economic Issues Branch
Office of European Analysis

SUBJECT : US-EC High Level Consultations

1. The attached material may be useful for officials in the Department of the Treasury who are preparing for the 9 December US-EC consultations. The package has also been sent to the Department of Commerce per a specific request. I have included a short paper on EC budget problems and the potential impact on the US; the Key Judgments to a forthcoming intelligence assessment, Western Europe: The Unemployment Crisis; and an intelligence assessment we completed last September, New Departures in European Political Cooperation.

2. At a SIG meeting I attended on 2 November 1983, Secretary Regan expressed interest in how the EC as an institution was developing. I suspect he would find the assessment on European Political Cooperation particularly useful. 25X1

3. If I can be of any further assistance, you can contact 25X1
me [redacted]

[redacted]

Attachments:
As stated

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25X1 [redacted] [redacted]

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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

2 December 1983

MEMORANDUM FOR: James Frierson
Special Assistant to the USTR
Office of the United States Trade Representative

FROM : [redacted] 25X1
Chief, Economic Issues Branch
Office of European Analysis

SUBJECT : US-EC High Level Consultations

1. Attached is material which I believe Ambassador Brock would find useful in preparing for the 9 December US-EC consultations. The package has also been sent to the Department of Commerce per a specific request. I have included a short paper on EC budget problems and the potential impact on the US; the Key Judgments to a forthcoming intelligence assessment, Western Europe: The Unemployment Crisis; and an intelligence assessment we completed last September, New Departures in European Political Cooperation. 25X1

2. If I can be of any further assistance, you can contact me [redacted]

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Attachments:
As stated

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European Community: Prospects for Budget Reform*

The EC summit in Athens on 4-6 December is supposed to wrap up an intense round of negotiations on EC budgetary reform, but few important decisions are likely to emerge; most major budgetary issues will probably be put off until next spring. At their Stuttgart meeting last June, EC leaders delivered a budgetary reform mandate to be carried out by the Athens summit. The mandate called for modifications in the Community's budget system so that each member shares more equally in its costs and benefits, and limitations on agricultural spending. The continuing budget morass will strain relations among Community members and increase the chances that the EC will limit agricultural imports in an attempt to contain domestic agricultural support expenditures. With the Athens summit unlikely to agree on new agricultural measures, the US-EC high level consultations on 9-10 December will provide the United States another opportunity to pressure the Ten not to seek external solutions to their agricultural spending problems.

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* This memorandum was prepared by [redacted] European Issues Division, Office of European Analysis. Comments and questions are welcome and may be addressed to the Chief, European Issues Division, EURA, [redacted] 25X1

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The Problem

EC expenditures have skyrocketed in recent years and are now approaching the legal cap on revenues. Over two-thirds of EC spending goes to farm support programs under the Common Agricultural Policy (CAP), and between 1976 and 1982 CAP expenditures rose at an annual rate of 17 percent. CAP costs rose because the program encourages overproduction -- the Community guarantees to buy surplus output at prices above world market levels. CAP expenditures are now running 40 percent ahead of last year despite low world commodity prices, and by early October the Community had spent 95 percent of its regular budget allocation. To some extent the EC has already been forced to contain spending; last month the Commission suspended advance payments on export subsidies and producer aids.

The EC must by law balance its budget, which forces the Community to live within the resources allocated to it by member governments. The largest and only readily expandable source of EC revenue is value added tax (VAT) receipts, which accounts for over 50 percent of Community funds. The other major source of money is customs duties raised through the Community's Common External Tariff. In 1975 the EC members agreed that up to 1.0 percentage point of each country's VAT would be made available for the Community budget as needed. In 1982 the EC needed to use 0.92 percentage point of the VAT to cover expenses; we expect the 1.0 percentage point ceiling will be reached in 1984. Although

revenues from VAT and customs duties rise with inflation and economic growth, EC spending is certain to outstrip revenue expansion next year.

The EC faces a more fundamental problem than keeping farm spending within revenue limitations: distributing the budgetary burden equitably. It is this issue that will preoccupy the leaders at Athens. The UK especially has complained about its net budget payments and is demanding changes. Britain is one of the Community's poorer members, ahead of only Greece, Italy and Ireland in terms of per capita GDP. The UK pays disproportionately into the EC because a higher portion of its trade is with countries outside the Community, so it generates larger customs duties which all go into EC coffers. Britain receives relatively less CAP payments than other members because it has a smaller and more efficient farm sector. Thus, the UK receives the equivalent of $41 per capita from the EC whereas average Community-wide per capita spending is $54.

Since 1980 British demands for financial restitution have been met by annual rebates agreed to after much wrangling among EC members. Last year's rebate negotiations, however, were especially acrimonious. After much pressure from the European Parliament, EC leaders committed themselves at Stuttgart to find a permanent structural solution to the "British problem." West Germany has joined the UK in complaining about the size of its EC payments, but Bonn has signalled its willingness to remain a

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large net contributor. West Germany is the richest Community member and is a major beneficiary of the open EC market for manufactured goods.

Potential Solutions

The leaders at Athens will address three interrelated measues to shore up the Community's finances: an immediate revenue increase to replenish the EC treasury, a reapportionment of net budget shares, and CAP reforms to curb runaway farm spending.

The easiest way for the Community to remain solvent is to expand "own resources" by raising the VAT ceiling. Some countries, particularly France, Ireland and Italy, profit from present arrangements and favor this simple means of increasing Community finances. The Commission has proposed raising the ceiling to 1.4 percentage point of VAT, which should provide sufficient revenues for 3-5 years. Greece, which presently holds the EC Presidency, has proposed a ceiling of 1.8 percent which could resolve the issue for up to a decade.

Any increase in the VAT ceiling, however, must be passed by all ten national parliaments and the UK and West Germany have said that they will agree to an expansion of "own resources" only after the Stuttgart mandate has been fulfilled. They insist on budget reforms to insure permanent reductions in their EC payments and demand that a lid be placed on agricultural spending. Other Community members recognize that Britain

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especially deserves some budgetary relief and favor some spending curtailments, but have resisted an overhaul of the system since they enjoy its benefits.

Eight separate budgetary proposals aimed at redistributing budget shares have been discussed in the Special Council, but none yet appears to have the support necessary for approval. The British have demanded a "safety net" which would place an absolute limit on the net annual contribution any member must make. This has been widely rejected but London has held fast to its demand that its grievances be addressed. At the other end of the spectrum is an EC Commission proposal for increasing EC expenditures in countries that are net contributors and have a per capita GDP that is below the Community average. Not coincidentally, only the UK falls in this category, but the British find the proposal highly prejudicial since it recalculates the amount of over-contributions and halves the amount of rebate the British claim. A Danish proposal for a "convergence fund" to step up EC expenditures in countries that are net contributors has gathered limited support but was cooly received by the UK. The Germans recently tabled a compromise package which combines the British notion of an upper limit on payments with the Danish plan for increased expenditures, and this may well be the focus of discussions at Athens.

The most likely target for cuts in agricultural spending is the dairy sector. The leaders will consider a proposal for a

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"super levy" which places additional taxes on excess dairy production. The heads of government will almost certainly also discuss restricting imports of feed grain substitutes such as corn gluten, and the French proposal for a vegetable oil tax. The question of revising the Community's elaborate system of Monetary Compensation Amounts, which is intended to guard CAP payments against currency fluctuations, will also be raised.

Prospects

The Athens summit is not likely to result in any important reforms such as recalculating budget shares or raising the amount of "own resources", but some movement on agricultural issues is possible. We believe that limited agricultural reforms, such at the dairy super levy, may be agreed to, but most budgetary questions will be put off until next year and may not come to a head until 1984 CAP price supports are set in the spring. Should the leaders not settle the budget issue they may scramble to agree on other unrelated matters, such as a new foreign policy initiative in the Middle East, to demonstrate their solidarity. In any event, the meeting is not likely to break down in rancor and bitterness. 25X1

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Given the immediacy of the "own resources" problem and the specter of empty Community coffers, we think that some interim

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budget solution may be found next year, but we doubt that the Stuttgart mandate to "revitalize" the Community will be fulfilled. Any interim solution must lift the VAT ceiling to inject desperately needed new cash into the EC. Whatever agreement may emerge must placate the United Kingdom and redistribute some of the budget burden, although West Germany will continue to shoulder a disproportionate share.

A permanent resolution of the overall budget issue must await restructuring of the CAP. Although no specific comprehensive CAP reforms packages are currently on the negotiating table, the most plausible solution is controlling production by halting the Community's open-ended guarantee to buy surpluses, especially in the grain and dairy sectors. This is a daunting task made especially difficult by the strong political power of EC farmers. We expect CAP reform to proceed slowly and inconclusively.

EC leaders are increasingly likely to externalize their agriculture problems by limiting agricultural imports from the US. Although no agreement on the fats and oils tax is likely, the leaders may agree to give the Commission a mandate to take the corn gluten issue to the GATT in an attempt to place a ceiling on imports from the US.

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Impact on the US

Should EC leaders not solve the budgetary problem at Athens, we doubt the Commission will be able to negotiate effectively when it meets with the US Cabinet on 9 December. Without progress at Athens the EC may conveniently plead that reforms are under discussion, but that the Community is not yet in a position to directly address US concerns. Although the US-EC consultations will give the United States another chance to influence CAP reform, strong US protestations will be resented by many EC members and portrayed as meddling in internal EC affairs. We believe the EC's inability to solve the problem of the CAP will cause recurring US-EC tensions.

Failure to find an internal solution to the budget problem will add to the growing conviction among some EC members that part of the cost of CAP reform should be borne by third countries, especially the US. The French, for example, have argued that if their farmers must suffer so must some exporters to the EC, and that measures such as import restrictions on corn gluten feed are necessary. The EC representative to the US has frequently stated that to cut CAP costs Community agricultural imports must be scrutinized. The Community may also take actions, such as the proposed tax on vegetable oils and fats, and justify them as domestic revenue measures when they actually shift part of the burden onto others. In our view, continued EC inability to rationalize the CAP and reform the budget will

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likely intensify EC competition with the US for third markets in agricultural goods because export subsidization is intregal to the current structure of the CAP.

EC: 1983 Budget

	Percent
Expenditures	
Agricultural Support	69.8
Regional Fund	6.9
Social Fund	6.7
Reimbursements to Members	5.3
Cooperation With Developing Countries	4.6
Administration	3.5
Research, Investment, Energy, etc.	2.6
Other Sectors	0.6
Revenues	
Value Added Tax	51.3
Customs Duties	35.1
Agricultural Levies	7.2
Sugar Levies	4.7
Misc. Revenues	0.9
Financial Contributions	0.8

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EC: Net Budget Contributions*, 1981

$ millions

	Before Rebate**	After Rebate**
Belgium/Luxembourg	-553	-441
Denmark	-261	-230
Germany	1379	1799
France	-576	-209
Ireland	-501	-489
Italy	-530	-329
Netherlands	-167	-87
United Kingdom	1316	117
Greece	-107	-82

* Minus sign indicates net receipts.

** "Columns do not add to 0 because of statistical discrepancies in EC accounting."

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Western Europe: The Unemployment Crisis*

We believe Western Europe faces a continued period of high unemployment, possibly averaging 12 percent through the end of the decade. While the public has shown an unusual tolerance for unemployment, this persistent trend will increase pressure on political and social institutions and disrupt US-West European economic relations:

- o By the second half of the 1980s, Western Europe may enter a period of frequent oscillation between governments of the left and right because incumbent leaders, unable to solve the unemployment problem will become increasingly vulnerable to opposition attacks.
- o Political extremism may become rampant among young people, as much of an entire generation of youth faces years of joblessness or underemployment.
- o In Spain and Turkey, where unemployment will remain extraordinarily high and will be coupled with rapid inflation and foreign debt difficulties, serious political instability could result.

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- Foreign workers increasingly will become targets of resentment by the unemployed, leading to social strains both within and among West European countries.
- Trade conflicts between Western Europe and the rest of the world will become more numerous and hotly contested as West European governments increasingly equate trade opportunities with job opportunities. Recent trade disagreements with the United States over steel and agricultural goods could become the rule not the exception and may spill over into other areas such as political and military cooperation. Moreover, the increasing importance of exports will put pressure on West European countries to relax -- or less strictly enforce -- trade restrictions on sales to the Soviet Bloc.
- As trade difficulties mount, protectionist pressures in Western Europe will grow. New barriers against US products likely will be limited, but restrictions against other countries, particularly Japan and the NICs may increase, forcing those countries to offset lost sales in Western Europe by boosting sales efforts in the United States.
- Dim unemployment prospects also will make it more difficult for West European countries to meet their defense commitments to NATO. Unemployment already has

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caused a severe fiscal drain on governments, and with budgets likely to remain tight, pressure to curb defense spending will mount. 25X1

Fundamental structural economic problems -- rapid growth of the labor force, accelerating labor costs, and inability to restructure industry -- are the main causes of Western Europe's unemployment problem; cyclical economic conditions are only a secondary factor. The unemployment rate in the region has been climbing almost continuously since 1970 and by mid-1983 reached over 10 percent. During the 1970s the total population increased very little but the prime working-age population (ages 25 to 54) grew at twice the increase of the previous ten years. Simultaneously, wages and non-wage labor costs skyrocketed, discouraging employers from expanding their work force and forcing them to reduce jobs through attrition. Western Europe's inability to move its employment base away from declining traditional industries into high growth areas further depressed job creation in the 1970s. 25X1

We do not expect Western Europe will be able to solve its structural unemployment problems quickly and as a result the number of unemployed will continue climbing albeit slowly thoughout the decade. Demographic trends will add even more prospective workers to the labor force than during the 1970s. Economic growth probably will be insufficient to offset the expansion of the labor force. Labor costs, on the other hand,

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should moderate in part because of high unemployment, but this marginal improvement alone will be insufficient to reverse the dismal unemployment trends. We see little chance for a significant pick up in the pace of industrial restructuring, thus employment growth will continue to be held back. 25X1

While the present course of macroeconomic policy should help to promote an economic climate more conducive to improved economic growth without rapid inflation, the underlying causes of Western Europe's unemployment problem are not in our view being adequately addressed. For the most part, governments are concentrating their efforts on employment programs -- such as reducing working hours and government subsidies for hiring long-term unemployed -- which do little more than redistribute the present unemployment. Few countries are implementing plans that encourage overall employment by holding down non-wage labor costs on employers; nor are governments actively trying to reduce public intervention in the economy -- a major factor slowing the restructuring process. Moreover, governments are continuing to prop-up outmoded, uncompetitive industries rather than promote investment in new, more dynamic industries. 25X1

Most of the uncertainty in our assessment probably lies on the upside. Labor costs could moderate even more than we now expect, thus encouraging job creation. As workers continue to lose jobs and factories in traditional industries continue closing, unions may opt to preserve as many jobs as possible

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rather than press for higher wages. In addition, Western Europe may be able to restructure its industrial sector faster than we can foresee at present. Nascent efforts to move into high-technology areas may begin to pay off more quickly than we expect. Increased efforts to capitalize on existing technology through joint ventures with Japanese and US companies may help Western Europe become more competitive. Moreover, real economic growth may be more rapid than we now expect, particularly if the US recovery retains its momentum and the world trade picture improves. Nonetheless, even under the best conditions, we would expect these improvements to lower unemployment only marginally, leaving it still high by historical standards. 25X1

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